United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

ORIGINAL

74-1596

To be argued by
ARNOLD I. BURNS

United States Court of Appeals
FOR THE SECOND CIRCUIT

STUART D. WECHSLER, on behalf of himself and all others similarly situated,

Plaintiff-Appellant-Appellee,

—against—

SOUTHEASTERN PROPERTIES, INC.,

Defendant-Appellee-Appellant,

MONARCH FUNDING CORP., ANTHONY J. DEMATTEO, WILLIAM L. MANNING, JAMES HENRY, RONALD ULLENBERG, DAVID L. BOYD, H. T. BRADDOCK, GEORGE E. MCGEE, III and CHALMERS K. SMITH, and HENRY MCCORD, FORRESTER & RICHARDSON EDITH COOPER, and SCHNEIDER & BARATTA.

Defendants-Appellees.

BRIEF OF DEFENDANT-APPELLEE-APPELLANT SOUTHEASTERN PROPERTIES, INC.

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August 14, 1974

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BRIEF OF DEFENDANT-APPELLEE-APPELLANT SOUTHEASTERN PROPERTIES, INC.

The Issues Presented for Review

Plaintiff has elected not to process that portion of his appeal which sought review of the District Court's dismissal of his action against defendant-appellee-appellant Southeastern Properties, Inc. ("Southeastern") and others (342a).* Rather, he seeks here only to have this Court

* All "a" references are to pages in the Appendix; all "Br." references are to plaintiff-appellant's Brief.

overturn the District Court's discretionary rejection of his claim that Southeastern reimburse him for his litigation expenses in this aborted securities action (Br., p. 1). Plaintiff requests such relief despite the fact that he had commenced this action with full knowledge that the Attorney General of the State of New York (the "AG") had previously instituted an investigation into the very same transaction which formed the basis of his complaint herein.* Although characterized a class action, no such judicial determination was ever made. Instead, the action was dismissed as moot without serious objection by plaintiff (317a) when Southeastern resolved its dispute with the AG (347a). Pursuant to the terms of that resolution, Southeastern rescinded the public offering of its stock and offered the purchasers, including plaintiff, the full consideration paid by them for their securities (228a). In return for this refund plaintiff executed and delivered to Southeastern a release of all of his claims and demands against it (273a).

Plaintiff has also conceded (325a), and the District Court has found (350a-351a), that plaintiff played no role in any of the AG's determinations to institute, to maintain or to dispose of his state court proceeding against Southeastern.

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* The District Court, in refusing to order Southeastern to pay plaintiff his legal fees, nonetheless found that he had no prior knowledge of the AG's investigation. It is respectfully submitted, however, that in reaching this conclusion the Court inadvertently overlooked the unequivocal assertion in plaintiff's May 2, 1972 complaint herein (¶18) that "soon after the Public Offering and in March, 1972, the Attorney General of the State of New York commenced an investigation of the Public Offering and caused trading of the common stock of Southeastern to be halted in New York State." An identical allegation is contained in plaintiff's Amended Complaint (10a).

Moreover, Southeastern advised all of its shareholders, by letter dated March 27, 1972 (267a), of the AG's intercession in the matter.

In view of the foregoing, three specific issues are presented for review on this appeal:

1. Is a plaintiff entitled to be reimbursed for his litigation expenses from a defendant in a securities action which is dismissed as moot upon the resolution of a previously commenced governmental investigation, where the defendant did not benefit from that resolution and where the plaintiff has not established that "but for" his action that resolution would not have occured?

2. Is a plaintiff entitled to be reimbursed for his litigation expenses from a defendant in a securities action when, after such action has become moot, he released that defendant from all claims and demands which he may have against it?

3. Is the defendant in such an action entitled to be reimbursed for its litigation expenses from the plaintiff, where the action was unnecessary in light of a governmental agency's prior intervention in the exercise of its protective police powers and where the action was continued by the plaintiff, although mooted by the resolution of that governmental proceeding, solely to justify a claim for legal fees?

The Facts

(a) The AG's Proceeding

On March 17, 1972, trading commenced in a new public issue of Southeastern common stock which had previously been duly registered with the Securities and Exchange Commission (247a). A few business days later, the AG commenced his own investigation of this public offering on the

theory that the sale of Southeastern stock in New York violated that state's "blue sky" laws. He ordered trading in the stock to be suspended and promptly opined that the sale of the entire public issue should be rescinded (139a).*

Negotiations between the AG's office and representatives of Southeastern were immediately commenced (249a). These discussions continued unabated for several months without final resolution (122a) until, on September 12, 1972, the AG obtained an order in New York State Supreme Court directing that Southeastern's officers and directors, as well as a number of other persons named in that proceeding, appear at the state courthouse to be examined by the AG and that they produce, at the same time, a whole series of confidential and financial documents for the AG's perusal (131a).

These depositions never took place. Instead, Southeastern agreed to consent to the entry of an order satisfactory to the AG which would compel it to make a tender offer to repurchase its common stock at the original $5.00 offering price. On November 30, 1972 the Securities and Exchange Commission acted upon Southeastern's application, pursuant to its settlement agreement with the AG, for leave to effect a rescission of its public offering without an effective registration statement and issued an appropriate "no action" letter (250a). On December 21, 1972, a consent

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* Throughout the pendency of both the instant action and the AG's proceeding, Southeastern consistently argued that it was guilty of no wrongdoing (17a-19a). Although plaintiff in his Brief repeatedly seeks to tarnish Southeastern with a broad accusatory brush, it must be noted that his action was dismissed, and the AG's action resolved, without any finding of fault or other determination of wrongdoing on Southeastern's part. Moreover, Southeastern's guilt or innocence is not in issue on this appeal. Southeastern will therefore devote its presentation only to a rebuttal of plaintiff's claim for reimbursement of his litigation expenses.

judgment embodying this plan of rescission was signed and entered in the New York Supreme Court (228a *et seq.*).*

To date, virtually all shareholders have elected to accept Southeastern's offer (349a). Included in this group is plaintiff, who on April 13, 1973 returned 290 of the 300 Southeastern shares then in his possession for which he was paid his $5.00 per share purchase price. (Since plaintiff had previously sold his other 100 shares for $5.25 a share (104a), he has received all but $25 of his original $2,000 investment and still retains 10 shares of Southeastern common stock. Presumably, plaintiff avoided complete divestiture in an attempt to maintain a semblance of legal standing in this action.) At the same time, he delivered to Southeastern an instrument, dated April 13, 1973, in which he specifically and unequivocally released and discharged that company from "all manner of actions, causes of action, suits, claims and demands which [plaintiff] may have for any reason whatsoever against" it (273a).

(b) Plaintiff's Subsequent Action

Plaintiff did not commence this action until May 2, 1972, some five weeks after the AG had suspended trading in Southeastern stock and had sought rescission of the public offering (247a, 296a). At the time plaintiff had full knowledge of the scope of the AG's inquiry (10a). Nonetheless his attorney deliberately refrained from discussing this matter with that office until the end of June (321a), opting instead to proceed as if the entire initiative for this action was his. Indeed, the record fails to reflect even a single instance in this two year litigation that plaintiff ever

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* Since this transaction served to compensate all shareholders for whatever damages they may have suffered as a result of the allegations contained in the complaints in both this and the AG's action, it made unnecessary the continued prosecution of either proceeding.

sought to utilize the AG's investigation or assistance in the expeditious prosecution of this claim.

Conversely, plaintiff never provided the AG with any assistance in its proceeding. Indeed, plaintiff never even obtained any meaningful discovery in this litigation. From the commencement of this action until its dismissal on April 4, 1974, plaintiff's prosecution of this lawsuit remained in large measure static. Depositions were noticed but they were never commenced. A few minor interrogatories were propounded, but their answers were never followed up with more penetrating inquiries into the merits of plaintiff's claim. A discovery and inspection of Southeastern's records and files, or those of a co-defendant, never took place. In short, there can be no disagreement with the assertions of both Southeastern and the AG, and the finding of the District Court (347a-351a), that plaintiff made no contribution whatsoever to the efforts of the AG in prosecuting or concluding this matter (328a).

Although the resolution of the AG's state court action clearly should have brought an end to any flurry of legal activity by plaintiff, the exact opposite occurred. Upon learning that the instant action, which never had a legitimate *raison d'etre* from its inception, was threatened with extinction because of the AG's efforts, plaintiff began to lay the groundwork for his fee application. A series of interrogatories, having nothing to do with the instant action, was propounded to Southeastern (208a-209a). (They were addressed to the mechanics of the rescission proceeding which the AG and the Supreme Court were supervising in the state action.) When objections to these interrogatories were filed on grounds of irrelevancy and on the additional ground that plaintiff had released Southeastern from any and all claims and, as a consequence, had lost his standing to continue with this action (241a), plaintiff rushed to the

District Court and requested that it compel Southeastern to answer these interrogatories (199a-242a). The District Court found it unnecessary to resolve that motion. Instead, it granted Southeastern's cross-motion to dismiss this action and denied plaintiff's application for attorneys' fees and costs on the grounds that plaintiff in no way influenced the initiation or course of the AG's investigation (347a-351a).

POINT I

This is not a case where a defendant should be compelled to pay his adversary's litigation expenses.

This Court has recently had occasion to discuss the very limited situations in which a litigant may be permitted to recover the cost of maintaining his lawsuit. See *Grace* v. *Ludwig*, 484 F.2d 1262 (2d Cir. 1973), *cert. den.*, 40 L.Ed. 2d 110 (1974). The teachings of that case, as plaintiff himself admits (Br. pp. 8-9), are controlling in the present action. First, in order for a plaintiff to be reimbursed for his legal expenses, he must establish the existence of sufficient "special circumstances" to justify such an award; and, second, he must show that his litigation had succeeded in conferring a benefit upon the party from whom he seeks this reimbursement. As shall be demonstrated below, neither of these conditions has been satisfied by this plaintiff.

(a) There Are No Special Circumstances Justifying the Payment of any Legal Fee

As was noted in *Grace* v. *Ludwig*, *supra*, at the heart of any doctrine favoring the unusual award of attorneys' fees in a securities case must be a judicial determination that, without plaintiff's action, the investing public would have been victimized. Where such circumstances are found to

exist, the public interest compels a policy which would encourage the individual private investor to become a surrogate attorney general. Since securities violations frequently result in rather insubstantial injury to the separate members of the class, such a policy quite properly looks to reward the initiator of a successful lawsuit by causing the beneficiaries of his largess to reimburse him for his litigation costs (see pp. 12-14 *infra*).

On the other hand, Southeastern urges, as this Court itself suggested in *Grace*, that the award of attorneys' fees in a securities case should not be lightly given. It is manifestly not in the best interests of the orderly administration of justice, both by the courts and by the various state and federal administrative tribunals, to guarantee compensation to every member of the Bar who is fortunate enough to find a client with a sufficient nexus to the transaction to permit the pleading of a *prima facie* case. Nor would such a practice necessarily augur well for the continued viability of those state and federal agencies. As the *Grace* panel wisely noted (at p. 1271):

> "A precedent here [in awarding legal fees without special circumstances] would encourage intervention in comparable cases not only before the SEC but other agencies as well. The competition and maneuvering among counsel to assume the lead role would not only be disruptive of administrative procedures but might very well encourage agency inaction. The SEC was here charged with a responsibility and it presumably has the expertise to make the assessment required by the statute. The introduction of additional cooks might not only spoil the broth but paralyze the chef." *

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* To which we would add that the implementation of such a practice would almost certainly result in a host of new lawsuits and thereby increase enormously the already heavy burdens of the district courts.

Plaintiff's voluntary, and totally unnecessary, involvement in the very same dispute over which the AG had previously exercised jurisdiction has not apparently "paralyze[d] the chef"; however, this is certainly no reason to reward his attempted opportunism. The AG had the responsibility to enforce his state's securities laws. New York General Business Law, § 352 *et seq.* Not only does his office enjoy a national reputation for its aggressive protection of the public interest, but his accomplishments in the state court action confirm his expertise in this area. Accordingly, the AG needed no help in seeking to right the alleged wrong, and none was ever given him by this plaintiff. The record in this case amply demonstrates that plaintiff was well satisfied to coast along in the AG's wake. It is through no contribution by plaintiff that the impact of the AG's investigation proved sufficient to compel the return to almost every member of the class his full investment in Southeastern while at the same time depriving Southeastern of the proceeds of its public offering.

Unlike the plaintiff in *Grace*, there is no claim by this plaintiff that he "pulled the laboring oar" in this litigation. He did nothing but sit back and await the final determination of the AG action, and then argue that there was really nothing more for him to do here but to consent to the dismissal of his action and to obtain reimbursement for his trouble. Southeastern respectfully submits that this passivity compels the denial of a discretionary award of legal fees in this action.*

The test to determine the existence of sufficient "special circumstances" to warrant an attorneys' fee award is

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* The plaintiffs in *Grace* actively contributed their extensive professional labors in the SEC proceeding, but they were denied compensation from the defendants since, among other reasons, their intervention was voluntary and unnecessary.

whether the result accomplished in the proceeding would not have occurred "but for" the plaintiff's intervention. *Grace* v. *Ludwig*, 484 F.2d at 1268. See also *Gilson* v. *Chock Full O'Nuts Corp.*, 331 F.2d 107 (2d Cir. 1964) where counsel fees were awarded because the corporation would not have benefited *except for* the services of the attorney who called the securities act violation to its attention. Significantly, neither plaintiff nor his attorneys here claim to have fulfilled such a decisive role. Rather plaintiff argues that he is entitled to be reimbursed for his litigation costs since there exists some causal connection between his commencement of this action and the AG settlement.

In order to evince that causal connection, plaintiff is reduced to reliance on only three circumstances (Br. p. 6): (1) that his complaint was able to withstand a motion to dismiss; (2) that Southeastern settled the AG action; and (3) that the District Court found that plaintiff's action "may have made Southeastern more amenable" to such settlement. We submit that in contending that these occurrences even suggest a causative relationship between plaintiff's conduct and the resolution of the AG action, plaintiff has succeeded in doing no more than demonstrating the very tenuousness of his claim.*

Even under Delaware law (see cases cited at pp. 6-7 of Plaintiff's Brief), the mere fact that a complaint has been held to plead a *prima facie* case is insufficient, without more, to establish a causal connection between that pleading and the benefit allegedly conferred by reason of the action. Indeed, the rule in that jurisdiction, as recited in *Chrysler*

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* This "causal connection" standard has been applied by the Delaware state courts (Br. pp. 6-7); it does not appear to be as stringent as the "but for" test governing the award of litigation expenses in securities cases in this Circuit.

Corp. v. *Dann*, 223 A.2d 384, 386-7 (Del. 1966), expressly demonstrates the lack of merit of plaintiff's contention:

> "This does not mean, however, that the mere filing of a derivative action against the corporation will justify the award of fees to plaintiff's counsel. Momentary reflection will demonstrate that to do so would encourage the filing of many such actions wholly lacking merit for the sole purpose of obtaining counsel fees. To guard against this undesirable result, therefore, the rule requires that not only must the action confer some benefit upon the corporation, but, also, that the action, when filed, was meritorious *and had a causal connection to the conferred benefit.*" (Emphasis added.)

And at p. 389:

> "Since the . . . plaintiffs failed to establish that their claims had merit, *and that there was a causal connection between the litigation and the change in management*, it follows that they are entitled to no award based on benefit conferred by the change in management." (Emphasis added.)

The *Chrysler* case also held that, for a claim to be sufficiently meritorious to justify the award of counsel fees in Delaware, it must not only be sufficiently pleaded, but the plaintiff must possess actual knowledge of provable facts which hold out some reasonable likelihood of ultimate success (see Br. at 6-7a). Plaintiff on this appeal, however, has conceded his inability to satisfy this requirement, for he has sworn that he possesses no knowledge of the facts underlying those paragraphs of his complaint which allege a securities act violation (107a).

Plaintiff's second purported basis for his claim is likewise insufficient to demonstrate the requisite causalty, for

it is self-evident that the mere fact that Southeastern has settled the AG state court action in no way reflects upon its motivation for entering into that agreement.

Finally, we respectfully submit that not only is there nothing in the record to support any finding by the District Court about what "may" have occurred, but such a conclusion is certainly speculative and does not justify a determination that such special circumstances exist as would compel an award of attorneys' fees.

Plaintiff seems to contend (Br. pp. 7-8) that the fact that his suit was mooted by reason of Southeastern's settlement of the AG action is sufficient to entitle him to attorneys' fees here. But this argument must fall, not only for the reasons stated above, but because such a doctrine would, as a practical matter, severely hamper the amicable resolution of disputes with administrative agencies. *Cf. Pennsylvania* v. *Williams*, 294 U.S. 176, (1939). As this Court recently had occasion to comment in *City of Detroit* v. *Grinnell Corp.*, 495 F.2d 448, 469 (2d Cir. 1974):

> "For the sake of their own integrity, the integrity of the legal profession, and the integrity of Rule 23, it is important that the courts should avoid awarding 'windfall fees' and that they should likewise avoid every appearance of having done so."

Clearly plaintiff here seeks a "windfall" and just as clearly it should be denied him.

(b) Southeastern Has Not Benefited From Plaintiff's Conduct

It is equally apparent from *Grace* v. *Ludwig*, *supra*, that an award of attorneys' fees in a securities action may only be justified if to do otherwise would permit an unjust enrichment. For example, where a defendant corporation

benefits from a plaintiff's successful maintenance of a derivative action, elemental fairness compels the corporation to pay the plaintiff the costs which it would have itself expended had it elected to maintain the action. See *e.g.*, *Smolowe* v. *Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943). Similarily, in a successful class action, it is only appropriate that members of the class who have benefited from the plaintiff's representation pay his legal fees out of recovered funds. See, *e.g.*, *Fleischmann Distilling Corp.* v. *Maier Brewing Co.*, 386 U.S. 714 (1967). Even in a situation where a plaintiff has not succeeded in creating a fund but instead has established the right of non-participating third parties to recover from the defendant *in futuro*, Southeastern readily concedes that there can be no serious disagreement with reimbursing that plaintiff for his litigation costs out of the fund from which these third parties will later benefit. See *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *Sprague* v. *Ticonic Nat'l Bank*, 307 U.S. 161 (1939).

However, by no stretch of the record facts in this case can it be said that Southeastern was enriched by plaintiff's conduct. *Cf. Grace* v. *Ludwig*, *supra* (484 F.2d at 1269). Indeed, it is patently obvious that, whether taken separately or in conjunction with each other, the actions by the AG and by plaintiff had only a debilitating, damaging effect on Southeastern: that company was permanently enjoined from certain specified conduct in the State of New York; it was compelled to return the proceeds of its public offering; it was forced to undertake the expenses of a tender offer; it was permanently placed within the continuing jurisdiction of both the New York Supreme Court and the AG; and it was compelled to pay costs to the AG in the sum of $2,000 (228a-231a). We submit that, while the rescinding shareholders of Southeastern may well be described as beneficiaries of that settlement, Southeastern simply does not fall within this category.

Southeastern does not contend, as plaintiff alleges (Br. p. 12), that attorneys' fees should never be awarded in a situation where a private action is based upon allegations first made in a governmental action. The facts in each case must of course be considered, and if the private litigant has satisfied the policy requirements enumerated in *Grace* v. *Ludwig, supra*, then he has earned his reward and is entitled to receive it. It was this rationale, for example, which permitted an award of attorneys' fees to those plaintiffs in the several Texas Gulf Sulphur litigations who had attained benefits for the members of their class which did not flow directly from the prior SEC action.

On the other hand, if the private suit was unnecessary; if under the hard analysis of hindsight it served no useful purpose; if the governmental action could and did accomplish all that was sought in the private action; then from the viewpoints both of judicial economy and of the administration of justice, it would be improper for the court to exercise its equity discretion and bestow such an unearned benefit upon the private litigant.

POINT II

Plaintiff has released Southeastern from any obligation to pay his litigation expenses.

On April 13, 1973, after plaintiff and his attorney were advised that the AG's action was resolved, and after his purported right to legal expenses had been finalized, plaintiff delivered to Southeastern a duly executed release of all claims and demands which he might have against Southeastern "for any reason whatsoever" (273a). Under these circumstances, it is hornbook law that Southeastern has a complete defense to plaintiff's claim for his litigation expenses. We therefore respectfully submit that, for this reason alone, the decision of the District Court must be affirmed.

POINT III

Plaintiff should be ordered to compensate Southeastern for its litigation expenses.

This Court has recently reaffirmed, in *Stolberg* v. *Members of the Board of Trustees*, 474 F.2d 485, 490 (2d Cir. 1973), that where an action is maintained or prosecuted vexatiously and without good cause, the adverse party has a right to receive compensation for his legal expenses. See also *Newman* v. *Piggie Park Enterprises, Inc.*, 390 U.S. 400 (1968). Southeastern respectfully submits that plaintiff's conduct in needlessly instituting and maintaining the instant action falls within this category of actions and, as a consequence, he should be compelled to reimburse Southeastern for its litigation expenses.

CONCLUSION

We respectfully submit that the record amply supports the District Court's conclusion that plaintiff has not earned an award of litigation costs in this action, and indeed he has waived any such claim. There being no clear abuse of that Court's discretion in denying plaintiff a judgment in this respect, we submit that the order of the District Court should be affirmed. Moreover, plaintiff should be directed to reimburse Southeastern for its litigation expenses and the costs of this appeal.

Respectfully submitted,

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August 14, 1974

Service of ~~three (3)~~ Two (2) copies of the within Brief is hereby admitted this 19th day of August, 1974

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Service of ~~three (3)~~ Two (2) copies of the within Brief is hereby admitted this 4 day of August 74

Hart & Hanson

Attorney(s) for Hanson et al

Service of ~~three (3)~~ Two (2) copies of the within is hereby admitted

this 14th day of August

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Attorney(s) for

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